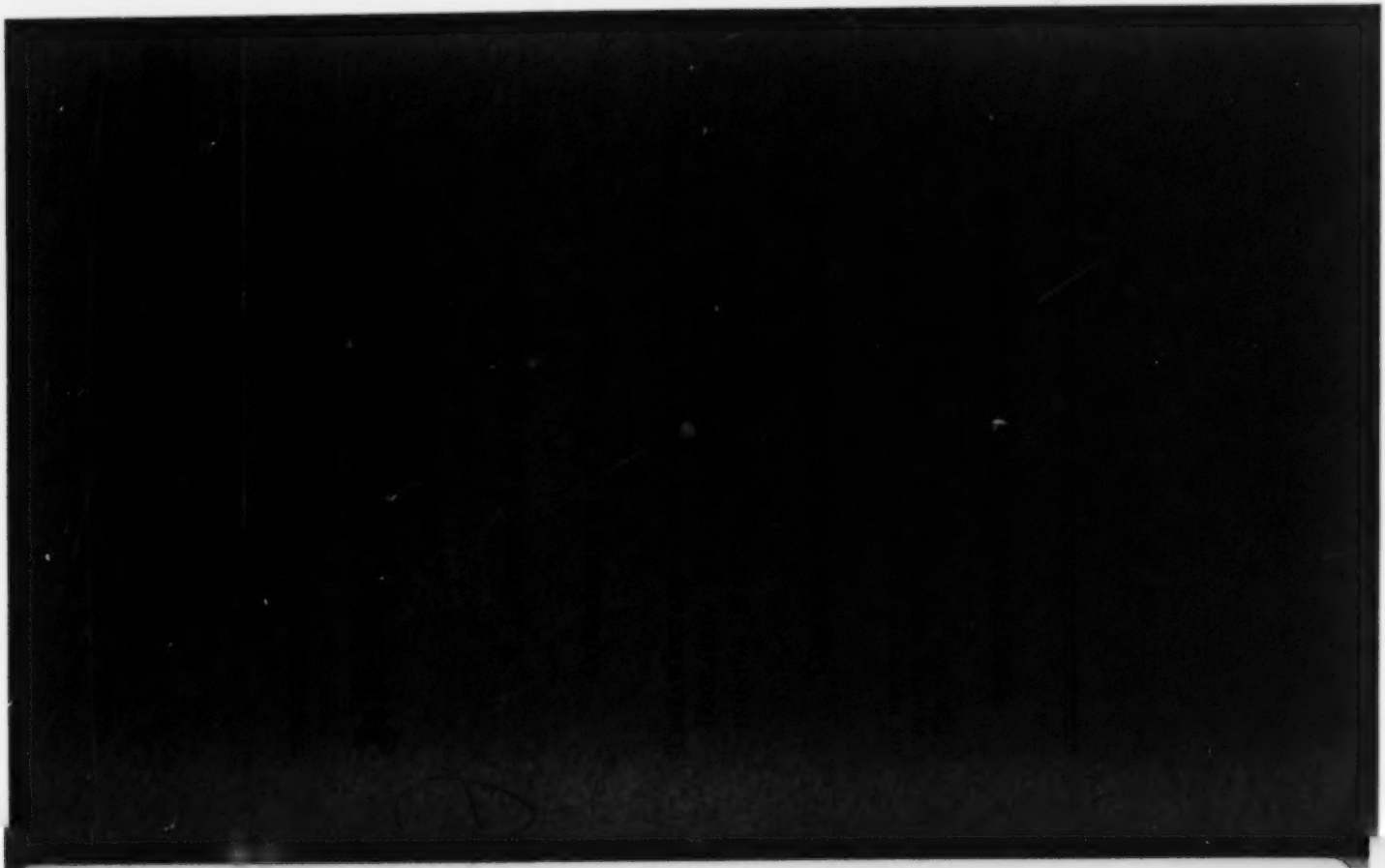

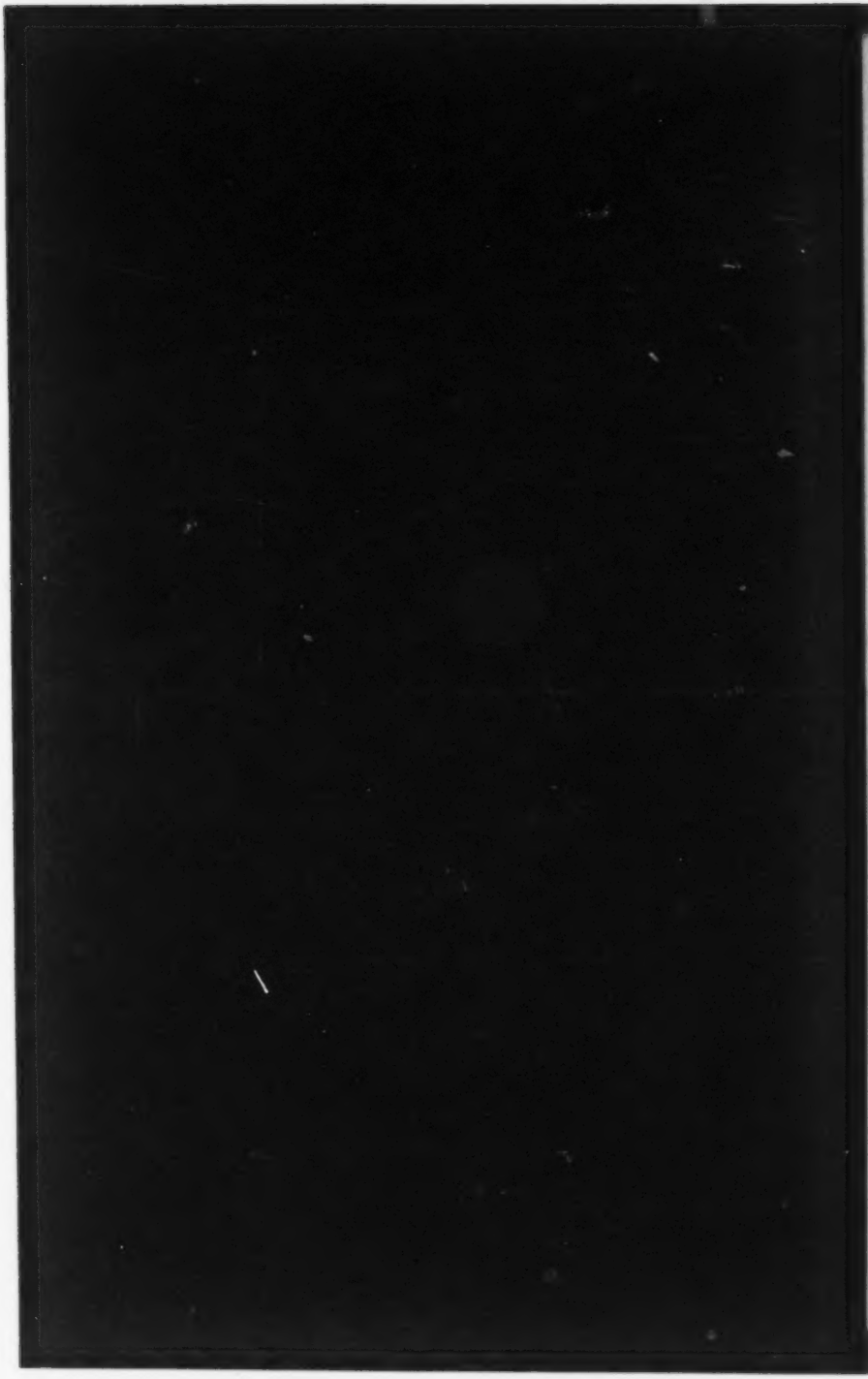

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 455

S. LIVINGSTON MATHER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 456

TESTAMENTARY TRUST U/W OF SAMUEL MATHER, DECEASED, WILLIAM G. MATHER AND S. LIVINGSTON MATHER, TRUSTEES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court's opinion (R. 175–184) is unreported. The opinion of the Circuit Court of Appeals (R. 199–205) is reported at 149 F. 2d 393.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered May 23, 1945. (R. 197, 198.) A petition for rehearing was denied July 2, 1945. (R. 207.) Separate petitions for writs of certiorari were filed September 26, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayers were residuary legatees of the estate of a person who, as accommodation comaker, had executed a joint note with his son-in-law. The estate's assets were transferred to a corporation which assumed the debts, and later, on dissolution of the corporation, its assets were distributed to the taxpayers in proportion to their original interests in the estate subject to payment of the decedent's debts, including the liability on the joint note. The son-in-law was insolvent at the date of the decedent's death and at all times thereafter.

The question is whether the taxpayers are entitled to bad debt deductions under Section 23 (k) of the Internal Revenue Code equal to their payments on the note.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 23 [as amended by Section 124 of the Revenue Act of 1942, c. 619, 56 Stat.

798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) *Bad Debts.*—

(1) *General Rule.*—Debts which become worthless within the taxable year; * * * (26 U. S. C., Sec. 23.)

STATEMENT

These proceedings were consolidated in the Tax Court and in the court below. The pertinent facts were summarized by the Tax Court as follows (R. 176–179):

Petitioners were residuary legatees under the will of Samuel Mather who died testate on October 18, 1931, a resident of Cuyahoga County, Ohio. (R. 176.)

Prior to June 1, 1931, Robert H. Bishop, Jr., the husband of Mather's daughter, Constance, had become financially involved. Mather loaned Bishop securities which the latter pledged with a brokerage firm as security for his account there. Still the account was short and the brokerage firm threatened to liquidate the collateral. To protect his securities so pledged by Bishop and to provide Bishop with funds to meet his various obligations, Mather arranged a loan at the Guardian Trust Company of Cleveland, Ohio, in the amount of $3,566,000. The loan was evidenced by a joint and several promissory note executed and delivered by Mather and Bishop, dated June

1, 1931, due one year from date and secured by collateral having a market value of approximately $4,650,000. Of the securities so pledged, $500,000 worth belonged to Bishop, $1,750,000 worth belonged to his wife and $2,400,000 worth belonged to Mather. The proceeds of the loan, plus $130.24 in cash furnished by Bishop, were disbursed by the bank in payment of Bishop's debts including that in favor of the brokerage firm. The securities owned by Mather which were pledged to it were surrendered and became a part of the collateral provided by Mather to secure the joint note. Mather did not make a gift to Bishop as a consequence of the above described transaction. (R. 176.)

No payment having been made on the principal of the joint note prior to Mather's death, a claim was filed and allowed against the Mather estate in the face amount of the note. Bishop, at the time of Mather's death, was insolvent and wholly unable to pay any amount on any unsecured obligation owed by him and he has been so ever since. The executors of the Mather estate and the Commissioner engaged in a controversy over the amount of the federal estate tax due. As finally settled, the estate was allowed as a deduction in computing the value of the net estate the amount of the joint note plus interest accrued to the date of death less the value of the pledged securities belonging to Bishop and his wife, or $2,281,944.23. (R. 176–177.)

In order to provide time for the ultimate payment of obligations of the estate and thus avoid a disastrous liquidation and to provide for the distribution of assets to the legatees under Mather's will, a corporation, Samuel Mather Estate, Inc., was created and a contract was executed by the interested parties on November 13, 1933, calling for the acquisition of the estate's assets by the corporation subject to all debts and liabilities of the estate in the order of their priority in exchange for stock. The corporation agreed to issue jointly with Bishop Series A collateral trust notes in an aggregate principal amount equal to the balance due on the joint note plus interest to December 31, 1934. It also agreed to issue Series B collateral trust notes in an amount sufficient to settle the unsecured obligations of the estate. Both series of notes were to be issued pursuant to a trust indenture. The corporation's assets were to be deposited and pledged with the trustee under the trust indenture as security for the payment of the notes. This contract was approved by the Probate Court of Cuyahoga County, Ohio, and its terms thereupon were carried out. The executors of Mather's estate duly transferred to the corporation all the property and assets of the estate in a tax-free exchange whereby they received 11,465 shares of the corporation's Class A preferred stock, 4,000 shares of its Class B preferred stock, 4,000 shares of its Class C preferred stock and 1,000 shares of its common stock. The

Class B preferred stock was distributed in a way not here material. The Class A preferred, the Class C preferred and the common stock were distributed to the various legatees under Mather's will in proportion to their interests in the estate. Class A preferred was distributed to specific legatees and Class C preferred and common stock was distributed to the residuary legatees including the petitioners herein. Petitioner in No. 455 received 1,000 shares of Class C preferred and 250 shares of the common. Petitioners in No. 456 received 250 shares of Class C preferred and 62½ shares of the common. The corporation assumed the payment of the debts, obligations and liabilities of the Mather estate including its obligation on the joint note. Among the assets of the estate so transferred to the corporation were the securities which had been pledged as security for payment of the joint note. They were transferred subject to such lien. The Series A notes, due December 31, 1939, were delivered to the holders of the joint note in the way of additional evidence of the indebtedness, the holders of the joint note thereby agreeing to make no demand for payment of the joint note unless the Series A notes fell into default. The Series B notes, also due December 31, 1939, were delivered to the unsecured creditors of the estate and accepted in full payment of their respective claims (R. 177–178.)

Coincident with the transfer of the estate assets to the corporation, an agreement was made by and between the executors of the estate, the corporation, Bishop and Constance wherein Bishop acknowledged and agreed that the joint note had been executed by Mather as an accommodation to him; that he was indebted to the executors for the interest and principal which they had paid on the joint note; and that he would thereafter be indebted to the corporation in this amount plus all further payments which the corporation would make on the joint note and the Series A notes to be issued by it and Bishop jointly. The executors, by the same instrument, assigned their claim against Bishop to the corporation. Constance agreed that the securities belonging to her and pledged to secure the joint note might be applied toward payment of the joint note. (R. 178.)

In December, 1938, a plan of complete liquidation of the corporation was adopted and effectuated to have the benefit of the provisions of Section 112 (b) (7) of the Revenue Act of 1938. As a consequence, the petitioners received their pro rata share of the assets of the corporation in kind, subject to all existing liens thereon, in complete cancellation and redemption of their stock in the corporation. In accordance with the plan petitioners, as well as the other common stockholders of the corporation, agreed to assume

the payment of the corporation's debts in proportion to their common stock holdings, but only out of the assets transferred to them in exchange for their common stock or any other property into which such assets might be converted. Thus petitioners in Nos. 455 and 456 assumed the payment of ¼ and 1/16 of each debt, respectively. Among such debts was the unpaid balance due on the joint note in the amount of $1,403,715.22. (R. 178–179.)

The collateral owned by Constance was sold and applied in reduction of the balance due. During the taxable year, 1939, petitioners in Nos. 455 and 456 paid, respectively, $120,145.35 and $48,898.98 on the joint note. The fair market value of the properties received by the petitioners upon the liquidation of the corporation was many times greater than the portion of the indebtedness on the joint note which they assumed and agreed to pay and was in excess of the fair market value of their share of the Mather estate as of the date of Mather's death. The aggregate value of the securities distributed by the corporation to the stockholders less the debts assumed by the latter exceeded the net estate of Mather upon which was based the federal estate tax. (R. 179.)

The petitioners claimed bad debt deductions under Section 23 (k) of the Internal Revenue Code on the theory that Bishop became indebted to them to the extent of their payments on the

joint note and that the debts so created instantaneously became worthless by reason of Bishop's insolvency. (R. 179.) The Tax Court sustained the Commissioner's disallowance of the claimed deductions (R. 184) and the Circuit Court of Appeals for the Sixth Circuit affirmed (R. 205).

ARGUMENT

The petitioners' claim below to a bad debt deduction under Section 23 (k) of the Internal Revenue Code, *supra,* relied mainly upon *Shiman* v. *Commissioner,* 60 F. 2d 65 (C. C. A. 2d) (R. 179, 202), and it is now asserted that the decision below is in conflict with that case. (Pets. 9, Brs. 20–24). The general rule, as approved by this Court, is that a bad debt deduction is not allowable where "the debt was worthless when acquired." *Eckert* v. *Burnet,* 283 U. S. 140, 141.

However, regardless of whether the *Shiman* case is to be treated as carving an exception out of the general rule, it is inapplicable here, as amply demonstrated by the opinions of both courts below. The income tax liability of an accommodation maker of the note is not involved. The taxpayers here are residuary legatees, entitled to a specified portion of the decedent's estate *after* the payment of all debts, charges, etc. But the mere fact that distribution occurred *before* payment of the debt, thereby increasing the gross amount receivable by the residuary legatees, can-

not be made the means whereby those legatees obtain income tax deductions upon payment of the debts out of the distributed property. No such question was present in the *Shiman* case.

Nor is the decision below in conflict with *Commissioner* v. *Breyer,* C. C. A. 3, decided August 31, 1945 (1945 C. C. H., par. 9398) which involves a claim for deduction for interest with respect to the tax liability of a decedent's estate that was discharged out of assets of the decedent in the hands of a legatee. The court in that case distinguished between interest which had accrued up to the date of distribution to the legatee and interest accruing thereafter; the deduction was allowed only as to the latter. A companion case, *Commissioner* v. *Koppers,* decided in the same opinion, raising the same question as between predecessor and successor corporations makes clear that those cases involve special problems relating to transferee liability under the tax laws.[1] Moreover, the *Breyer* opinion does not purport to depart from the fundamental principle, controlling here, that income tax deductions cannot be predicated upon the payment by one taxpayer of the obligations of another, voluntarily assumed.

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[1] The Government intends to petition for certiorari in the *Breyer* and *Koppers* cases in view of the square conflict which exists between the decision therein and *Nunan* v. *Green,* 146 F. 2d 352 (C. C. A. 8); *Commissioner* v. *Henderson's Estate,* 147 F. 2d 619 (C. C. A. 5); *Commissioner* v. *Green,* 148 F. 2d 157 (C. C. A. 9).

Interstate Transit Lines v. *Commissioner,* 319 U. S. 590; *Deputy* v. *du Pont,* 308 U. S. 488; *Welch* v. *Helvering,* 290 U. S. 111.

Eisner v. *Macomber,* 252 U. S. 189 and the other remaining decisions relied upon by petitioners are far removed from the present controversy.

CONCLUSION

The decision below is correct and no conflict in decisions is presented. It is respectfully submitted that the petitions for writs of certiorari should be denied.

Respectfully submitted.

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In the Supreme Court of the United States

OCTOBER TERM, 1945.

No. 455.

S. LIVINGSTON MATHER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

No. 456.

TESTAMENTARY TRUST u/w OF SAMUEL MATHER, DECEASED, WILLIAM G. MATHER AND S. LIVINGSTON MATHER, TRUSTEES,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

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In the Supreme Court of the United States

OCTOBER TERM, 1945.

No. 455.

S. LIVINGSTON MATHER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

No. 456.

TESTAMENTARY TRUST u/w OF SAMUEL MATHER, DECEASED, WILLIAM G. MATHER AND S. LIVINGSTON MATHER, TRUSTEES,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

ERRORS IN FACTUAL STATEMENTS.

The following will correct certain misstatements of fact as contained in Respondent's Brief under "Question Presented" and "Statement."

1. Taxpayers were not "residuary legatees" of Samuel Mather, either at the time the Estate Company was liquidated in 1938 or in 1939, the income tax year here in question. Years prior to 1938, all rights of residuary legatees of that estate had been fully satisfied, the estate wound up, and the executors discharged. Thus, at all times here in question, taxpayers were not residuary legatees of such estate.